Multistate Tax Commission Memorandum

States Working Together Since 1967 . . . To Preserve Federalism and Tax Fairness

To:	Members of the MTC Executive Committee
From:	Shirley Sicilian, Deputy General Counsel
Date:	May 1, 2006
Subject:	Proposed Amendment to Model Regulation Regarding Income Producing Activity Performed "On Behalf Of" the Taxpayer

I. Summary

This memorandum explains the Uniformity Committee's proposed amendment to MTC Regulation IV.17 regarding income producing activity performed "on behalf of" a taxpayer. The proposal is now before the Executive Committee for approval for public hearing. In general, under the Multistate Tax Compact, if a taxpayer has a receipt from a transaction other than a sale of tangible personal property, that receipt is assigned to the numerator of the sales factor of the state where the income producing activity is located. Under current regulations, income producing activity "does not include the transactions and activities performed on behalf of a taxpayer, such as those conducted by independent contractors." The Uniformity Committee's proposal would eliminate that exclusion.

Section II of the memorandum summarizes the proposal's procedural background. Section III reviews the current rule on this issue. Section IV explains the problems with the current rule, and Section V describes how the Uniformity Committee's proposal would address those problems. Section VI lays out the array of possible next steps for the Executive Committee.

II. Procedural Background

An amendment to MTC Reg. IV.17. was first proposed at the November, 2004 Uniformity Committee meetings by the Committee's representative from California (Mr. Michael Brownell, California- FTB). At that meeting, the Committee expressed interest in the proposal, and asked that a white paper be prepared explaining the rationale for such an amendment. A white paper was drafted by Mr. Brownell and presented to the Income & Franchise Tax Uniformity Subcommittee at its March, 2005 meetings, and, after discussion and an opportunity for public comment, the Subcommittee voted to initiate a uniformity project to address the proposal. On July 24, 2005, the white paper was again presented to the Income & Franchise Tax Uniformity Subcommittee, along with a draft proposed amendment. After discussion and an opportunity for public comment, the Committee voted to recommend the proposed amendment favorably to the Uniformity Committee. On July 25, 2005, after further discussion and opportunity for public comment, the full Uniformity Committee voted to recommend the proposal to the Executive Committee for public hearing.

The MTC Executive Committee considered the proposed amendment at its meeting on July 27, 2005. At that meeting, the Executive Committee expressed concern

that the proposal may have moved too quickly through the uniformity process to ensure adequate review and input from member states and the business community. The Committee sent the proposal back to the Uniformity Committee, and requested that the proposal be given additional consideration, via teleconference, and brought back to the Executive Committee at its November, 2005 meetings.

The Income & Franchise Tax Uniformity Subcommittee met via teleconference to further consider the proposal on September 20, 2005 and October 18, 2005. At those teleconference meetings, the Subcommittee received additional input both from member states and the business community. A small drafting group consisting of two members of the Uniformity Subcommittee (Mr. Carl Joseph, California – FTB; Ms. Andrea Chang, California-FTB) and MTC staff was formed to incorporate changes to the draft based on the additional input. On November 6, 2005, the Income & Franchise Tax Uniformity Committee met again to consider the redrafted proposal and take public input. Another small work group consisting of two members of the Uniformity Subcommittee (Ms. Leonore Heavey, Louisiana; Mr. Carl Joseph, California – FTB) and MTC staff incorporated additional changes based on the input received. On November 7, 2005, the Subcommittee again considered the proposal and offered another opportunity for public input. After further discussion, the Subcommittee voted to recommend the proposal favorably to the full Uniformity Committee. On November 7, 2005, the full Uniformity Committee voted to recommend the proposal favorably to the Executive Committee for public hearing. (The proposal is attached as Appendix A).

On November 10, 2005, the revised proposal came before the Executive Committee for possible approval for public hearing. After Committee review and discussion, and another opportunity for public input, the Committee determined discussion should be continued at its next meeting, scheduled for January 5, 2006. Following the Executive Committee's November meeting, a small group of Uniformity Committee members (Mr. Ted Spangler, Idaho; Mr. Carl Joseph and Ms. Andrea Chang, California – FTB) and MTC staff drafted amendments to the Uniformity Committee proposal that would address comments made by Executive Committee members. (The proposal showing these possible amendments is attached as Appendix B). The January 2005 Executive Committee meeting was cancelled, and the proposal was placed on the Agenda for the next scheduled Executive Committee meeting, May 10, 2006.

III. Substantive Background

Under the Multistate Tax Compact (Compact), a multistate company's business income is apportioned among the states in which it does business in accordance with a three factor apportionment formula. The three factors are property, payroll and sales.[1] The sales factor for each state is defined as a fraction, the numerator of which is equal to gross receipts attributable to that state, and the denominator of which is equal to total gross receipts.[2] The amount of gross receipts attributable to a state is determined in one of two ways, depending on whether or not the business income to be apportioned arises from a sale of tangible personal property. If the business income does not arise from the sale of tangible personal property (i.e. it arises from the sale of services or intangibles, or

[1] Multistate Tax Compact, Art. IV.9. Note: Article IV of the Compact incorporates the Uniform Division of Income for Tax Purposes Act (UDITPA).
[2] *Ibid*, Art. IV. 15.

the lease of tangible or intangible property), then the gross receipts from that transaction are attributable to that state if the "income producing activity" which gave rise to the receipts is in that state.[3] If the income producing activity takes place in more than one state, then the receipts are attributed to the state with the greater income producing activity, based on the "cost of performance."

The Multistate Tax Commission is charged with the responsibility to develop model regulations interpreting the terms of the Compact.[4] In 1972, MTC Model Regulation IV.17. was adopted to interpret the terms "income producing activity" and "cost of performance." Under MTC Reg.IV.17(2), income producing activity "applies to each separate item of income and means the transactions and activities directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit." The regulation further states that income producing activity "does not include the transactions and activities performed on behalf of a taxpayer, such as those conducted by independent contractors." It is common for a taxpayer that contracts to perform a service to delegate or subcontract a portion, and sometimes all, of the actual performance of the contract to a third party. However, under this rule, any portion of taxpayer's activity which has been so delegated is excluded from the calculation of taxpayer's "income producing activity." A cost paid to an entity that performs all or part of the service on the taxpayer's behalf is not considered part of taxpayer's cost of performance for purposes of determining where the receipt from that service will be attributed in calculating taxpayer's sales factor numerator.

To illustrate: Assume a taxpayer contracts with a customer to perform a service for $1 million, and hires a subcontractor that performs the service on the taxpayer's behalf in state B. Assume that the taxpayer will incur costs of its own in State A of $100,000, and will pay $500,000 to the subcontractor to perform the rest of the service in State B. If the costs paid to the subcontractor acting on behalf of the taxpayer are disregarded, the greater cost of performance ($100,000) is located in State A, and the $1 million sale would be in numerator of the State A sales factor. If the costs paid to the subcontractor acting on behalf of the taxpayer were considered, the greater cost of performance ($500,000 of $600,000) would be located in State B and the $1,000,000 sale would be in the numerator of the State B sales factor.

IV. Concerns with the Current Regulatory Language

A. Application Vague

The scope of the "on behalf of" actors whose activities may be disregarded is not clear. There is a range of possible actors that include 1) employees, 2) members of a combined reporting group, 3) members of a unitary group not included in the combined group, 4) affiliated but not unitary corporations, 4) individuals or corporations acting as agents,[5] and 5) individuals or corporations acting as independent contractors.

---

[3] *Ibid*, Art. IV. 17.
[4] *Ibid*. Art. VI. 3(b) and Art. VII.1.

[5] For purposes of this discussion, an agent is a person or entity sufficiently acting under the control and supervision of a principal so as not to be considered an "independent contractor."

While an employee in some sense acts "on behalf of" the corporation for which he or she is employed, a fairly strong argument can be made that the employee should be considered an extension of the taxpayer itself, and the employee's salary should not be disregarded as a cost of performance under the "on behalf of" rule.[6] Next in the range of "on behalf of" actors is a member of the taxpayer's combined reporting group. In a *Finnigan* state, the whole of the unitary enterprise is a "taxpayer" for apportionment purposes so it may be expected that acts by one unitary member "on behalf of" another would be treated as acts of component parts of the same "taxpayer." In a *Joyce* state, however, for purposes of the numerator of the sales factor, each "taxpayer" member of a combined reporting group is considered a distinct entity, and one could argue that the activity performed on behalf of the taxpayer by a subcontracting member of the combined group, and intercompany payments to that member, are not "income producing activities" of the prime contractor taxpayer that actually receives the receipt from its customer.

One could argue that the "on behalf of" rule should be ***limited to*** independent contractors. However, such an interpretation could arguably be inconsistent with language of the rule itself, which applies to those acting on behalf of a taxpayer "*such as*" independent contractors. The phrase "such as" implies that the scope of the "on behalf of" rule may be broader than independent contractors alone. Thus, activity performed and costs paid to a non-independent contractor agent (i.e., an agent under the control and supervision of its principal) might also be excluded from income producing activity and costs of performance under the "on behalf of" rule.

B. Potential for Manipulation

If non-independent (or dependent) contractors are within the scope of the "on behalf of" actors, a taxpayer would have a substantial planning opportunity. This opportunity arises because the taxpayer could essentially control the location of the numerator state by choosing to either perform the contract itself (in the example above, by performing the service itself in State B) or to hire an affiliate, possibly even a member of its combined group, to perform the contract (and thus, in the example above, shift the receipts to State A). A taxpayer wishing to exclude its cost of performance in a particular state could simply separately incorporate the segment of its business being performed in that state. State Departments of Revenue have begun to receive inquiries regarding whether or not this result from separate incorporation is indeed possible. Under the current rule, it appears it might be.[7]

C. Potentially Inadequate Statutory Support

---

[6] MTC Reg.IV.17(2)states "…Accordingly, income producing activity includes but is not limited to…: (A) The rendering of personal services by employees…in performing a service." Thus, the services (or at least the "personal" services) of an employee are considered income producing activities of the taxpayer.

[7] Of course, a separately incorporated entity operating in State B would have its own tax liability in State B and would attribute its own intercompany receipts to State B. However, this attribution would not produce the same result as if the taxpayer had performed the contract itself in State B. Even if the transaction is at arm's length, there would be a mark-up between what the subcontractor in state B charged its customer, the prime contractor in State A, and what the prime contractor charges the ultimate customer. This mark-up will not be reflected in the income sourced to state B. If the transaction is not at arm's length, the discrepancy could be much greater.

Of interest to this inquiry, in *General Motors Corp. v. Commonwealth*) [(Record No. 032533) (September 17, 2004) (Doc 2004-18598)] the Virginia Supreme Court held that third party costs should not have been disregarded in that state's cost of performance factor used for financial institutions. Virginia statute requires that the "taxable income of a financial corporation…shall be apportioned within and without this Commonwealth in the ratio that the business within this Commonwealth is to the total business of the corporation. Business within this Commonwealth shall be based on cost of performance in the Commonwealth over cost of performance everywhere." Virginia regulations defined the term "cost of performance" as used in the Virginia statute as "the costs of all activities directly performed by the taxpayer for the ultimate purpose of obtaining gains or profit." The regulation also provided that cost of performance did not include "activities performed on behalf of a taxpayer, such as those performed on its behalf by an independent contractor." The court found nothing in the language of the Virginia statute that limited the costs of performance to direct costs or anything to suggest that the department was permitted to exclude costs incurred for activities performed on behalf of a taxpayer by a third party.

There are certainly differences between the language of the Compact and the Virginia statute. Under the Compact:

> Sales, other than sales of tangible personal property, are in this State if:(a) the income-producing activity is performed in this State; or (b) the income-producing activity is performed both in and outside this State and a greater proportion of the income-producing activity is performed in this State than in any other State, based on costs of performance.
> Art.IV.17

And, under the MTC regs, "on behalf of" activity is excluded from income producing activity, rather than from the cost of performance. But the two statutes may not be different in any way that is relevant to the issue here. Under the Virginia statute, the apportionment factor is "cost of performance." Under the Compact, the apportionment factor is "income producing activity," but cost of performance is the means for quantifying the relative significance of the income producing activity in one state versus another. The Compact uses the term "income producing activity" as a kind of intermediate concept, rather than the bottom line apportionment factor, but ultimately apportionment still depends on the relative cost of performance.

Of course this decision is precedential only in Virginia. But it does point out a possible weakness in the current regulation.

D. Rationale for Rule Unclear

The origins of the "on behalf of" rule are unclear. There may be a hint of a rationale in the fact that amounts paid to independent contractors are also excluded from the payroll factor. These rules may have reflected a notion that acts of an independent contractor were remote from the acts of the taxpayer and thus not properly chargeable to the taxpayer. This would be consistent with the cases that pre-date *Scripto v. Carson* that adopted a principle that acts of an independent contractor were not acts of the party for whom they acted. Section 17 doesn't have a throwback rule, so if a cost of performance is incurred in a state where the taxpayer doesn't have nexus, there is no standard mechanism in that statute or regulation for preventing a "nowhere sale." On the other

hand, the view that an independent contractor doesn't confer nexus on the out-of-state seller was rejected in *Scripto*, at least in the context of a sales solicitation. *Scripto* was a 1959 case, decided well before the regulation was completed in 1972. However, if the independent contractor (or the independent contractor's own subcontractor) has discretion as to where its portion of the contract is performed, it is possible that *Scripto v. Carson* would not impute nexus to the taxpayer in the state where the subcontractor services are performed, on a theory that the acts in that state were not "purposefully directed" by the taxpayer. In that case, if amounts paid to an independent contractor would be considered a cost of performance, it would still be possible to have the greater cost of performance located in a state where the taxpayer does not have nexus.

Another reason the "on behalf of" rule might have been adopted is to avoid the audit difficulties associated with determining the location where the "on behalf of" actor actually performed its portion of the services under the contract. However, if the prime contract with the taxpayer's customer calls for the performance of a service in a specific state, or the service can only be done in that state (e.g., an earth-moving contract), it is not that difficult to identify the location where the "on behalf of" actor actually performed the service. On the other hand, the "on behalf of" actor might have discretion as to where its portion of the service is to be performed. For example, if a subcontractor is adding component value to an advertising contract, it might be able to perform its subcontracting services anywhere. In still other cases, a subcontractor might "outsource" its subcontracting services to still another party. As the actors become increasingly more remote from the prime contracting party, identification of the location of costs of performance could become increasingly difficult.

Any reversal of the "on behalf of" exclusion can and should address these two possible rationales for the current rule.

V. Proposed Amendment

A. Include Cost of Activity Performed "On Behalf Of" Taxpayer

The proposal from the Uniformity Committee would strike the exclusion of activity performed on behalf of the taxpayer from the definition of "income producing activity." Instead, the definition would include all of taxpayer's activity, regardless of whether it is performed by the taxpayer itself or by another entity acting on the taxpayer's behalf. The proposal would include the activity of all third party contractors, both dependent and independent. Treating all contractors similarly will avoid creating tax incentives or disincentives for taxpayers to contract with one over the other.

B. Address Potential Lack of Information Re Location of Activity

The proposal adopts a sequence of rules for determining the location of the taxpayer's income producing activity performed by a third party. Under the rule, the activity will be located where it actually takes place, if the taxpayer can make that determination. If the taxpayer cannot determine where the activity takes place, then the activity is sourced to the location specified by the contract between the taxpayer and the contractor, or if no such location is specified, then by the location specified for performance in the contract between the taxpayer and its customer. If neither contract specifies a location, then the activity is attributed to the location of the taxpayer's customer's (commercial) domicile.

C. Preclude "Look Through" to Subcontractor's COP

The purpose of the rule is to determine the location of the taxpayer's income producing activity, not the subcontractor's income producing activity. The taxpayer's income producing activity may be quantified using the taxpayer's cost of performance, not the subcontractor's cost of performance. Therefore, the only cost relevant to an inquiry regarding performance by a third party acting on behalf of the taxpayer, are the taxpayer's costs associated with that performance – the payments made by the taxpayer under the contract between the taxpayer and the subcontractor. In fact, taxpayer's payments to a subcontractor are "direct" costs to the taxpayer for the performance of the service being provided to taxpayer's customer. The costs should not include indirect costs such as the subcontractors cost of performing the service for its customer (the taxpayer). Nor should cost of performance include the costs of taxpayer activities that are not "directly engaged in …for the ultimate purpose of obtaining gains or profit," such as an assignment of costs for negotiating the contract with the subcontractor. This latter exclusion is consistent with the treatment of other direct costs, which include only the cost of taxpayer's personnel or property used to produce the item of income, and not the costs of negotiating the contract for that personnel or property.

D. Address Potential for Lack of Nexus

If the (commercial) domicile cannot be determined, or if the taxpayer does not have nexus in the state to which the rule would attribute the activity, then the activity is disregarded. The result is similar to a sales factor "throw-out" rule, although it only applies for purposes of determining the location of a particular receipt. It is not a throw-out of the receipt itself, which may still be attributed to some other state on the basis of the remaining costs – similarly to how the current rule would function.

VI. Next Step - Action by Executive Committee

The Uniformity Committee forwarded the proposal to the Executive Committee with a recommendation that it be approved for public hearing. The Executive Committee may take whatever action it deems appropriate. It may refer the proposal to public hearing (with or without changes, such as those proposed in Appendix B), refer the proposal back to the Uniformity Committee for additional work (with or without specific instructions), or terminate the project.

Appendix A

Draft Amendment to MTC Regulation IV.17
Regarding Treatment of Activities Performed "On Behalf Of" the Taxpayer

As Approved by the Uniformity Committee November 7, 2005
for Consideration by the Executive Committee to approve for Public Hearing
November 10, 2005

••• Reg. IV.17. Sales Factor: Sales Other Than Sales of Tangible Personal Property in This State

(1) In general. Article IV.17. provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government); under this section, gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance.

(2) Income producing activity: defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity ~~directly~~ engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income ~~obtaining gains or profit~~. Such activity ~~does not~~ includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:

(A) The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible and intangible property by the taxpayer in performing a service.

(B) The sale, rental, leasing, licensing or other use of real property.

(C) The rental, leasing, licensing or other use of tangible personal property.

(D) The sale, licensing or other use of intangible personal property.

The mere holding of intangible personal property is not, of itself, an income producing activity.

(3) Cost of performance: defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer to perform the income producing activity which gives rise to the particular item of income. Included in the taxpayer's cost of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services which give rise to the particular item of income.

(4) Application.

(A) In general. Receipts (other than from sales of tangible personal property) in respect to a particular income producing activity are in this state if:

(a) the income producing activity is performed wholly within this state; or

(b) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

(B) Special rules. The following are special rules for determining when receipts from the income producing activities described below are in this state:

(a) Gross receipts from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state.

(b) Gross receipts from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income producing activity from the rental, lease, licensing or other use of the same property while located in another state; consequently, if property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during that period.

Example: Taxpayer is the owner of 10 railroad cars. During the year, the total of the days during which each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income and shall be determined as follows:

$$\frac{(10 \times 50) = 500}{3650} \times \text{Total Receipts} = \text{Receipts Attributable to this State}$$

(c) Gross receipts for the performance of personal services are attributable to this state to the extent that such services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts from the performance of such services shall be attributable to this state only if the greater proportion of the services was performed in the state, based on costs of performance. Usually, where services are performed partly within and partly without this state, the services performed in each state will constitute a separate income producing activity; in such cases, the gross receipts from the performance of services attributable to this state shall be measured by the ratio which the time spent in performing the services in this state bears to the total time spent in performing the services everywhere. Time spent in performing services includes the amount of time expended in the performance of

a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example time expended in negotiating the contract, is excluded from the computations.

Example (i): Taxpayer, a road show, gave theatrical performances at various locations in State X and in this state during the tax period. All gross receipts from performances given in this state are attributed to this state.

Example (ii): The taxpayer, a public opinion survey corporation, conducted a poll by means of its employees in State X and in this state for the sum of $9,000. The project required 600 man-hours to obtain the basic data and prepare the survey report. Two hundred of the 600 man-hours were expended in this state. The receipts attributable to this state are $3,000.

$\frac{200}{600} \times \$9,000 = \$3,000$

(C) Services on Behalf of Taxpayer. An income producing activity performed on behalf of a taxpayer by an agent or independent contractor is attributed to this state if such income producing activity is in this state.

(a) Such income producing activity is in this state:

i. when the income producing activity is actually performed in this state by the agent or independent contractor, but if the activity occurs in more than one state, the location of the income producing activity shall not be determined under (4)(C)(a)(i);

ii. if it cannot be determined where the income producing activity is actually performed, when the contract between the taxpayer and the agent or independent contractor indicates it is to be performed in this state;

iii. if it cannot be determined where the income producing activity is actually performed and the independent contractor's contract with the taxpayer does not indicate where it is to be performed, when the contract between the taxpayer and the taxpayer's customer indicates it is to be performed in this state; or

iv. if it cannot be determined where the income producing activity is actually performed and neither contract indicates where it is to be performed, when the domicile of the taxpayer's customer is in this state. If the taxpayer's customer is not an individual, "domicile" means commercial domicile.

(b) If the location of the income producing activity by an agent or independent contractor cannot be determined under (4)(C)(a)(i) through (4)(C)(a)(iii), or the taxpayer's customer's domicile cannot be determined under

(4)(C)(a)(iv), or, although determinable, such income producing activity is in a state in which the taxpayer is not taxable, such income producing activity shall be disregarded.

Appendix B

Draft Amendment to MTC Regulation IV.17
Regarding Treatment of Activities Performed "On Behalf Of" the Taxpayer

Possible Amendments to the
Draft Approved by the Uniformity Committee November 7, 2005
and provided to Executive Committee on November 10, 2005

For Discussion Purposes Only
May 10, 2006

••• Reg. IV.17. Sales Factor: Sales Other Than Sales of Tangible Personal Property in This State

(1) In general. Article IV.17. provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government); under this section, gross receipts are attributed to this state if the income producing activity which gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance.

(2) Income producing activity: defined. The term "income producing activity" applies to each separate item of income and means the transactions and activity ~~directly~~ engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income ~~obtaining gains or profit~~. Such activity ~~does not~~ includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:

(A) The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the utilization of tangible and intangible property by the taxpayer in performing a service.

(B) The sale, rental, leasing, licensing or other use of real property.

(C) The rental, leasing, licensing or other use of tangible personal property.

(D) The sale, licensing or other use of intangible personal property.

The mere holding of intangible personal property is not, of itself, an income producing activity.

(3) Cost of performance: defined. The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer to perform the income producing activity which gives rise to the particular item of

income. Included in the taxpayer's cost of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services which give rise to the particular item of income.

(4) Application.

(A) In general. Receipts (other than from sales of tangible personal property) in respect to a particular income producing activity are in this state if:

(a) the income producing activity is performed wholly within this state; or

(b) the income producing activity is performed both in and outside this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

(B) Special rules. The following are special rules for determining when receipts from the income producing activities described below are in this state:

(a) Gross receipts from the sale, lease, rental or licensing of real property are in this state if the real property is located in this state.

(b) Gross receipts from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state. The rental, lease, licensing or other use of tangible personal property in this state is a separate income producing activity from the rental, lease, licensing or other use of the same property while located in another state; consequently, if property is within and without this state during the rental, lease or licensing period, gross receipts attributable to this state shall be measured by the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during that period.

Example: Taxpayer is the owner of 10 railroad cars. During the year, the total of the days during which each railroad car was present in this state was 50 days. The receipts attributable to the use of each of the railroad cars in this state are a separate item of income and shall be determined as follows:

$$\frac{(10 \times 50) = 500}{3650} \times \text{Total Receipts} = \text{Receipts Attributable to this State}$$

(c) Gross receipts for the performance of personal services are attributable to this state to the extent that such services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts from the performance of such services shall be attributable to this state only if the greater proportion of the services was performed in the state, based on costs of performance. Usually, where services are performed partly within and partly without this state, the services performed in each state will constitute a separate income producing activity; in such cases, the gross receipts from the performance of services attributable to this state shall be

measured by the ratio which the time spent in performing the services in this state bears to the total time spent in performing the services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example time expended in negotiating the contract, is excluded from the computations.

Example (i): Taxpayer, a road show, gave theatrical performances at various locations in State X and in this state during the tax period. All gross receipts from performances given in this state are attributed to this state.

Example (ii): The taxpayer, a public opinion survey corporation, conducted a poll by means of its employees in State X and in this state for the sum of $9,000. The project required 600 man-hours to obtain the basic data and prepare the survey report. Two hundred of the 600 man-hours were expended in this state. The receipts attributable to this state are $3,000.

$$\frac{200}{600} \times \$9{,}000 = \$3{,}000$$

(C) Services on Behalf of Taxpayer. An income producing activity performed on behalf of a taxpayer by an agent or independent contractor is attributed to this state if such income producing activity is in this state.

(a) Such income producing activity is in this state:

(i) when the taxpayer can reasonably determine at the time of filing that the income producing activity is actually performed in this state by the agent or independent contractor, but if the activity occurs in more than one state, the location ~~of~~ where the income producing activity is actually performed shall ~~not be determined~~ be deemed to be not reasonably determinable at the time of filing under (4)(C)(a)(i);

(ii) if ~~it cannot be determined~~ the taxpayer cannot reasonably determine at the time of filing where the income producing activity is actually performed, when the contract between the taxpayer and the agent or independent contractor indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or contractor associated with such performance is determinable under the contract;

(iii) if it cannot be determined where the income producing activity is actually performed and the agent or independent contractor's contract with the taxpayer does not indicate where it is to be performed, when the contract between the taxpayer and the taxpayer's customer indicates it is to be performed in this state and the portion of the taxpayer's payment to the agent or contractor associated with such performance is determinable under the contract; or

(iv) if it cannot be determined where the income producing activity is actually performed and neither contract indicates where it is to be performed or the portion of the payment associated with such performance, when the domicile of the taxpayer's customer is in this state. If the taxpayer's customer is not an individual, "domicile" means commercial domicile.

(b) If the location of the income producing activity by an agent or independent contractor, or the portion of the payment associated with such performance, cannot be determined under (4)(C)(a)(i) through (4)(C)(a)(iii), or the taxpayer's customer's domicile cannot be determined under (4)(C)(a)(iv), or, although determinable, such income producing activity is in a state in which the taxpayer is not taxable, such income producing activity shall be disregard